



DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

INSPECTOR GENERAL
for TAX
ADMINISTRATION

October 26, 2004

MEMORANDUM FOR COMMISSIONER EVERSON

A handwritten signature in black ink that reads "Pamela J. Gardiner".

FROM: Pamela J. Gardiner
Acting Inspector General

SUBJECT: Management and Performance Challenges Facing
the Internal Revenue Service for Fiscal Year 2005

SUMMARY

The Reports Consolidation Act of 2000¹ requires that we summarize, for inclusion in the *Department of the Treasury Accountability Report for Fiscal Year 2004*, our perspective on the most serious management and performance challenges currently facing the Internal Revenue Service (IRS). We provided a summarized version of this letter to Secretary Snow on October 14, 2004, for inclusion in that report (see attachment).

The Treasury Inspector General for Tax Administration's (TIGTA) assessment of the major IRS management challenge areas for Fiscal Year (FY) 2005 has not changed substantially from the prior year. While the IRS has acted to address each challenge area, we were unable to remove any challenge area at this time. We have, however, removed the subtitles previously included for two areas – Security of the Internal Revenue Service and Integrating Performance and Financial Management. The narrative for each primary category describes the issue as a whole; therefore, the subtitles are no longer needed.

We believe the major management challenges, in order of priority, facing the IRS in FY 2005 are:

- Systems Modernization of the Internal Revenue Service
- Tax Compliance Initiatives
- Security of the Internal Revenue Service
- Integrating Performance and Financial Management
- Complexity of the Tax Law
- Providing Quality Customer Service Operations
- Erroneous and Improper Payments

¹ Pub. L. No. 106-531.

- Processing Returns and Implementing Tax Law Changes During the Tax Filing Season
- Taxpayer Protection and Rights
- Human Capital

The Office of Audit's [FY 2005 Annual Audit Plan](#) categorizes the planned audits by these issues. If you have questions, please contact me at (202) 622-6510 or your staff may contact Tammy L. Whitcomb, Director, Office of Management and Policy at (202) 622-5896.

DISCUSSION

Discussion of the major IRS management challenge areas, including examples of relevant TIGTA audit work, follows.

Systems Modernization of the Internal Revenue Service

Modernization of IRS' computer systems will likely remain on the management challenge list for years to come. The latest effort to modernize IRS' systems, mandated by the IRS Restructuring and Reform Act of 1998 (RRA 98)² and started in FY 1999, is expected to take 10 to 15 years at a cost of \$7 to \$10 billion. Dramatic improvements in service to taxpayers are heavily dependent on modernizing the core computer systems. The systems must also provide an infrastructure that is sufficiently flexible to adapt to evolving business needs, and one that can be efficiently managed.

The IRS and the PRIME³ contractor have deployed projects that provide value to taxpayers and have built the infrastructure needed to support these projects. In addition, the IRS has developed an enterprise architecture to guide the Business Systems Modernization (BSM) program. Even though progress is being made, the IRS and its contractors have drawn increased criticism due to continuing schedule delays and cost increases. As a result, pressure has been mounting from various oversight groups to deliver a successful program. In addition to TIGTA reports and Congressional testimony, the Government Accountability Office (GAO) testified that recently identified weaknesses were consistent with previous GAO findings.⁴ Also, in December 2003, the IRS Oversight Board released a special report detailing actions needed for the IRS and the PRIME contractor to succeed.⁵

To obtain fresh and independent assessments from outside experts on the health of the BSM program, the IRS launched a comprehensive review consisting of three studies and a BSM benchmarking analysis. In addition, the PRIME contractor launched an internal study. The studies resulted in 21 recommendations for improving the BSM program, 15 of which are

² Pub. L. No. 105-206, 112 Stat. 685 (codified as amended in scattered sections of 2 U.S.C., 5 U.S.C., 5 U.S.C. app., 16 U.S.C., 19 U.S.C., 22 U.S.C., 23 U.S.C., 26 U.S.C., 31 U.S.C., 38 U.S.C., and 49 U.S.C.).

³ The Prime Systems Integration Services Contractor (PRIME) is the Computer Sciences Corporation, which is responsible for designing new systems to meet IRS business needs, developing these systems, integrating them into the IRS, and ultimately transferring operation of these systems to the IRS.

⁴ *Business Systems Modernization: Internal Revenue Service Needs to Further Strengthen Program Management* (GAO-04-438T, dated February 2004).

⁵ *Independent Analysis of IRS Business Systems Modernization* (dated December 2003).

similar to those made in TIGTA reports issued during the past 3 years. In several instances, the principal recommendations were reported multiple times during this period. Since many prior TIGTA recommendations have resurfaced as part of the recent studies, the TIGTA concludes that BSM weaknesses continue to exist and that the IRS and its contractors need to complete planned corrective actions to address the root causes identified in the studies.

Over the past 2 fiscal years, the TIGTA has cited four primary challenges the IRS and its contractors must overcome to be successful: 1) implement planned improvements in key management processes and commit necessary resources to enable success, 2) manage the increasing complexity and risks of the BSM program, 3) maintain the continuity of strategic direction with experienced leadership, and 4) ensure PRIME contractor performance and accountability are effectively managed. Based on the results of recent TIGTA audits, as well as the study findings, we believe these four challenges still need to be met to achieve program success.¹

To address the results of the recent studies, the IRS and the PRIME contractor have developed and are implementing a 48-point action plan, known as the *BSM Challenges Plan*. While the planned corrective actions should help improve the BSM program, it will take time to institutionalize new processes and ensure they are being followed. Only at that time will it be possible to determine if the actions have effectively addressed the four major challenges.

Tax Compliance Initiatives

The IRS continues to face challenges in administering programs that deal with tax gap issues, especially those resulting from corporate and high-income individual taxpayer corrosive activities as well as domestic and off-shore tax and financial criminal activity. For some time, the IRS, the Congress, and other interested stakeholders have been concerned because tax compliance has been slowly eroding. Therefore, the challenge to IRS management is to establish a tax compliance program that identifies those citizens who do not meet their tax obligations, either by not paying the correct amount of tax or not filing proper tax returns.

The IRS is endeavoring to revise its compliance program by reengineering the collection and examination practices. Some improvements have been noted. For example, the level of compliance activities and the results obtained in many Collection function areas in FY 2003 showed a continuing increase while the number of Collection function field staff remained unchanged. Use of collection enforcement tools including liens, levies, and seizures increased substantially from lows experienced in FYs 1999 and 2000. The number of liens filed exceeded the FY 1997 level; however, the number of levies and seizures are still substantially lower than their pre-1998 levels. The President's proposed FY 2005 budget provides for additional Collection function staffing and legislation to allow some cases to be worked by contract staff. However, if neither of these provisions is approved, a significant number of cases will remain unworked.

The Examination function staffing decreased during FY 2003; however, the percent of tax returns examined increased, mainly due to increases in correspondence examinations of tax returns for individuals, which are conducted by mailing notices to the taxpayer. While there were increases in the number of individual examinations overall during FY 2003, there was a larger increase in the coverage rate of individuals earning \$100,000 and over than for those

under \$100,000. In addition, there was a significant increase in the number of partnership return examinations. The number of corporate tax return examinations, however, continued the decline that started in FY 1997, decreasing a total of 67 percent since that time. The President's proposed FY 2005 budget provides for additional Examination function staffing, and the Commissioner has indicated that some of the increase would be allocated to corporate compliance.ⁱⁱ

While the IRS has made some progress in reengineering its processes, there are other actions that IRS could take to enhance its compliance activities. For example, a TIGTA auditⁱⁱⁱ found that the IRS could expand the use of money laundering referrals and currency transaction information for compliance purposes. The Bank Secrecy Act⁶ requires banks and nonbank financial institutions, such as check cashing businesses and casinos, to file information reports regarding significant currency transactions. Thus, this information could be reviewed for potential tax violations as part of the examination selection process.

Another TIGTA review^{iv} concluded that earlier intervention with delinquent taxpayers is needed to prevent noncompliance with estimated tax payment requirements. Estimated tax is the method used by individual taxpayers to pay taxes on nonwage income on a quarterly basis. About 12 million taxpayers made estimated tax payments totaling \$183 billion for Tax Year (TY) 2001. However, there is significant taxpayer noncompliance with estimated tax requirements. For each tax year from 1995 through 2000, between 5.7 million and 6.8 million individual taxpayers were assessed penalties for making insufficient or late estimated tax payments. Many of these taxpayers also filed tax returns reporting unpaid taxes that resulted in the IRS having to take costly collection actions.

Five factors contribute to estimated tax noncompliance. First, the tax law does not require tax withholding on nonwage sources of income. Second, the quarterly due dates prescribed by law for making estimated tax payments do not consistently coincide with the calendar quarters and are irregularly spaced from 61 to 122 days apart. Third, the estimated tax penalty rate, which is currently only 4 percent, may not sufficiently deter payment noncompliance. Fourth, the IRS has no early intervention programs to identify taxpayers that stop making estimated tax payments or that make insufficient or untimely payments. Finally, the IRS has experienced little success (i.e., only about 1 in 200 taxpayers) in encouraging the use of electronic payment options for making estimated tax payments. Without proactive efforts by the IRS, the noncompliance with estimated taxes can be expected to worsen in the years to come, since the amount of income from nonwage sources is growing significantly faster than that from wages.

The IRS recognizes that abusive tax schemes involving tax-exempt and government entities appear to have grown. In addition, after the events of September 11, 2001, there is a need to ensure charitable assets are not diverted for illegal or other non-charitable purposes. For FY 2005, the IRS is shifting its emphasis by increasing examination coverage of the most egregious abusers, including those that promote and use abusive tax schemes and avoidance transactions. The variety, size, and nature of tax shelters and other abusive transactions require an organized approach to detection, deterrence, and enforcement. A

⁶ Pub. L. No. 91-508, 84 Stat. 1114 to 1124 (1970) (codified as amended in scattered sections of 12 U.S.C., 15 U.S.C., and 31 U.S.C.). Regulations for the BSA, and other related statutes, are 31 C.F.R. § 103.11-103.77 (2002). The Secretary of the Treasury has delegated the authority to administer Title II of the BSA to the Director of the Financial Crimes Enforcement Network.

TIGTA review^v determined that the Tax Exempt and Government Entities (TE/GE) Division has recently begun to develop a Division-wide program to address abusive tax avoidance transactions within its customer segments.

In addition to the compliance reengineering initiatives, additional steps could be taken to assure that financial criminals comply with conditions of sentences relating to settlement of civil tax liabilities. A recent TIGTA audit^{vi} found that existing procedures within the Criminal Investigation (CI) function and the Small Business/Self-Employed (SB/SE) Division did not effectively ensure convicted criminals who did not settle IRS tax liabilities were reported to the courts for appropriate legal action even though that was a conditional term of the sentences.

Security of the Internal Revenue Service

As the nation's primary revenue collector, the IRS is a prime target for both terrorists and hackers. This threat has increased over the last few years as a result of both internal factors (such as increased connectivity of systems) and external factors (such as the volatile threat environment resulting from increased terrorist activity). In addition, IRS systems and data are vulnerable to unhappy taxpayers and disgruntled employees as well as natural disasters. Although many steps have been taken to limit risks, IRS systems and taxpayer information remain susceptible to threats that could impact the confidentiality, integrity, and availability of data and information systems.

For the last 3 years, TIGTA assessments have concluded that the security infrastructure and the applications that guard sensitive data are weak because of inadequate accountability and security awareness as well as insufficient training for key security employees. The primary causes are management and operational issues, not technical ones. However, the IRS has placed more focus on technical solutions than on management and operational concerns. For example, a recent TIGTA report^{vii} stated that while security roles and responsibilities have been defined, we continue to identify significant security weaknesses throughout the IRS that we attribute to employees not fulfilling those responsibilities. The end result is that the IRS still does not have an organizational culture that places strong emphasis on the security and privacy of taxpayer data. In addition, some disaster recovery plans require additional development, testing, or personnel training to assure that the IRS can quickly recover in the event of a disaster.

One recent TIGTA report^{viii} discussed security concerns with the Infrastructure Shared Services (ISS) architecture. The ISS is intended to provide a secure technical infrastructure to support and enable the delivery of the IRS' modernized business systems, and was the first BSM project to undergo the security certification testing processes required by the Office of Management and Budget (OMB) and the Department of the Treasury. Although many challenges were encountered during this process, the completion of the ISS in May 2002 was a critical step in providing opportunities for the development and deployment of all other BSM projects. Several security weaknesses in the ISS, however, had not been adequately addressed.

Another TIGTA report^{ix} showed that the IRS made commendable progress in certifying its many computer systems, but additional work remains to be performed before the computer security material weakness can be downgraded. The IRS has initiated efforts to revamp

the certification process by placing all of its systems into one of four categories and has established certification requirements. Other reviews reported that sensitive technology information was posted on the Internet^x and that some equipment, when synchronized to a network computer, provided a backdoor into the network and could bypass existing security detection controls. The IRS, for example, has over 2,000 uncertified Personal Digital Assistants (PDA) that can connect to the IRS network. The portability of PDAs and their capacity to store sensitive data pose significant security risks for the IRS because, even though PDAs can perform many of the same functions as laptop computers, they lack multiple security controls that are available for laptops and other computers.^{xi}

To promote better performance and consistent customer focus, in October 2003, the IRS combined key security activities previously found in the Agency-Wide Shared Services, Communications and Liaison, and Modernization and Information Technology Services offices into a single organization. The Mission Assurance is a partner organization under the Deputy Commissioner for Operations Support. While the IRS has become a leader in Government under this concept, it is important to remember that security is everyone's responsibility. Thus, IRS business unit managers should be held accountable for the security of their systems and key security employees should be adequately trained to carry out their responsibilities. It is also vital that the IRS continues to refine its plans and capabilities to manage emergency situations and deal with them in a manner that protects employees and allows restoration of business operations in a timely manner. In addition, aggressive network control, monitoring and incident response capabilities are necessary to prevent incursions into IRS systems from external and internal sources.

Integrating Performance and Financial Management

*The President's Management Agenda*⁷ includes both Budget and Performance Integration and Improved Financial Performance among its five Government-wide goals. The Administration hopes to place a greater focus on performance by formally integrating it with budget decisions. In addition, without accurate and timely financial information, it is not possible to accomplish the President's agenda to secure the best performance and highest measure of accountability for the American people. The IRS has made some progress; however, integrating performance and financial management remains a major challenge.

The IRS recently issued its 5-year Strategic Plan for FY 2005-2009, building on its first plan issued in January 2001. This process provides the IRS with an excellent opportunity to improve its strategies and program plans for customer service, enforcement, and productivity. It also affords the IRS the opportunity to develop mid-range (3- to 5-year) process and outcome performance measures with specific targets for many of its major programs and activities.

The IRS has had mixed success in establishing its long-term goals. During the FY 2005 budget formulation process, the IRS took the important step of aligning performance and resources requested. The IRS also modified its budget and performance plans to include more customer-focused and "end result" measures and recently implemented the "Embedded Quality" program/methodology to gauge the accuracy of completed actions.

⁷ *The President's Management Agenda*, announced in the summer of 2001, is an aggressive strategy for improving the management of the Federal government. It focuses on five areas of management weakness across the Government where improvements and the most progress can be made.

However, the TIGTA believes the IRS must continue to integrate performance into its decision-making and resource allocation processes to completely achieve an integrated performance budget.

The IRS also continues to analyze the critical data needed to develop long-term enforcement outcome measures. For example, the National Research Program is expected to provide fresh data on taxpayer voluntary compliance levels – the first in more than a decade. Such data is essential to establishing enforcement measures and effectively allocating resources to related activities. The IRS, however, needs to develop a more strategic approach to the entire tax administration system. This effort would go a long way toward identifying the characteristics of an effective and efficient tax administration system, help identify desired outcomes, and create a road map for the next decade that would complement the IRS' strategic, budget, and annual performance plans.

The IRS' financial statements and related activities also continue to be of concern to IRS stakeholders. Because of the significance of IRS collections to federal receipts and, in turn, to the consolidated financial statements of the Government, as well as Congress' interest in financial management at the IRS, the GAO audits the IRS' financial statements annually to determine whether the IRS: 1) prepared reliable financial statements, 2) maintained effective internal controls, and 3) complied with selected provisions of significant laws and regulations, including compliance of its financial systems with the Federal Financial Management Improvement Act of 1996 (FFMIA).⁸

In its audit of the IRS' FY 2003 financial statements, the GAO concluded that the records were fairly presented in all material respects.⁹ The GAO, however, identified some continuing serious deficiencies in the IRS' financial systems, including control weaknesses and system deficiencies affecting financial reporting, unpaid tax assessments, tax revenue and refunds, and computer security. Even so, the GAO recognized IRS' progress in improving the accuracy and reliability of its property and equipment inventory records and implementing a system to ensure that software and software licenses were properly controlled and used in accordance with license agreements. However, the IRS again had to rely extensively on resource-intensive compensating processes to prepare its financial statements. Without a financial management system that can produce timely, accurate, and useful information needed for day-to-day decisions, the IRS' financial stewardship responsibilities continue to be one of the largest challenges facing IRS management.

The IRS began to implement portions of the planned functionality of the Integrated Financial System (IFS) in October 2004. This system represents a key element of the corrective actions being taken by the IRS to ensure its accounting system is in compliance with the Joint Financial Management Improvement Program's (JFMIP)¹⁰ *Federal Financial Management System Requirements*, and provides accurate and timely financial information for management decision making. However, a recent TIGTA audit report^{xii} stated that although progress has been made to include JFMIP requirements in the system design, the IFS either does not include functionality required by various accounting standards or has

⁸ Pub. L. No. 104-208, 110 Stat. 3009.

⁹ *Financial Audit: IRS's Fiscal Years 2003 and 2002 Financial Statement* (GAO-04-126, dated November 2003).

¹⁰ The JFMIP is a joint undertaking of the United States Department of the Treasury, the GAO, the Office of Management and Budget, and the Office of Personnel Management working in cooperation with each other and other agencies to improve financial management practices in the Federal Government.

had workarounds initiated by the IRS to compensate for the missing functionality. As a result, the IRS may not be in compliance with the FFMIA, which requires that agencies implement and maintain systems that comply substantially with Federal Government accounting standards and requirements.

Along with financial accountability, the Federal Government has a stewardship obligation to prevent fraud, waste, and abuse and to use tax dollars appropriately. The Office of Procurement, a key partner in delivering the IRS mission, awards and manages obligations that amount to nearly 20 percent of the IRS budget. Most mission critical programs rely on contract support. Competitive sourcing, an initiative in *The President's Management Agenda*, will increase the Office of Procurement's workload. Additionally, congressional concerns have been raised regarding the propriety of payments to Government contractors. TIGTA audits have also identified some issues in the contract area. For example, a recent audit of the Nationwide Electronic Tax Forum Conferences and Exhibitions Contract showed that the contractor's documentation did not adequately support the tax forum income and expenses reported to the IRS for FYs 2002 and 2003.^{xiii}

Complexity of the Tax Law

The scope and complexity of the United States Tax Code make it virtually certain that taxpayers will face procedural, technical, and bureaucratic obstacles in meeting their tax obligations. Although the IRS has consistently and commendably sought to ease the process for all taxpayers, each tax season brings new problems. Additionally, some older problems stubbornly resist solution.

Tax administration comprises approximately 80 percent of the overall paperwork burden imposed by the Federal Government. In its new Strategic Plan, the IRS includes, as part of its goal to improve service to taxpayers, an objective to simplify the tax process. This could incorporate a range of actions from developing legislative recommendations to clarifying tax instructions or forms. Changing tax law, however, can be a lengthy process since the IRS only administers the tax code that is passed by the Congress and the President. Thus, the IRS must work extensively with stakeholders, including the Department of Treasury, to identify and develop legislative recommendations that would reduce tax law complexity and taxpayer burden.

Besides tax law, other factors that can contribute to the complexity issue include unclear IRS instructions, interpretations of the laws, and language barriers. Therefore, the IRS must first analyze systemic data and identify the impact various tax law provisions might have on taxpayers. Using the results of these analyses, the IRS can then revise forms and publications to help taxpayers better understand the tax law. Computer modernization, too, has a role in simplifying the tax process. For example, the current *e-file* system can be modernized to provide a single standard for filing electronic tax returns with the IRS, allowing those who transmit tax returns to submit multiple return types in the same transmission.¹¹

Besides adding to the taxpayer burden, tax law complexity also may have inadvertently contributed to the tax gap. Complexity has given rise to the latest generation of abusive tax avoidance transactions, with taxpayers attempting to take advantage of the tax code's

¹¹ IRS' FYs 2005 - 2009 Strategic Plan, page 15.

length and complexity by combining a myriad of technical rules to claim tax benefits not intended by the Congress. These transactions often involve complicated structures and sophisticated financial instruments that IRS agents must penetrate to determine whether a transaction is, in fact, abusive. These so-called “technical tax shelters” proliferated in the 1990s because taxpayers and promoters believed that taxpayers could enter into aggressive transactions with little risk of detection or, if caught, would owe nothing more than the tax due plus interest.

Providing Quality Customer Service Operations

Customer service is one of the primary goals that the IRS includes in its recently released updated 5-year Strategic Plan. The IRS’ goal to improve taxpayer service includes helping the taxpaying public understand their tax obligations while making it easier to participate in the tax system. Customer service is also a concern of the Congress and other stakeholders.

Every year, the IRS helps millions of taxpayers understand their obligations under the tax code by answering questions on its toll-free telephone lines or in person at local offices, making information available on its Web site, and responding to correspondence. The IRS’ success rate in achieving these goals has been mixed. Examples from recent TIGTA reports follow.

The IRS provided taxpayers with effective and improved access to its toll-free telephone system during the 2004 Filing Season,¹² providing over 872,000 more toll-free telephone services to taxpayers than in the prior year. The improved experience was evident in many of the measures the IRS uses to monitor its call center operations. First, callers were able to connect with the IRS more easily. Second, callers wanting to speak with a Customer Service Representative (CSR) received better service. Finally, the measures associated with the speed of handling calls showed improvements. As a validation of these accomplishments, surveys completed by callers to the IRS toll-free telephone system during the 2004 Filing Season showed that the vast majority of customers were satisfied with the services they received.^{xiv}

While CSRs exceeded goals in each of the key measures of professionalism and timeliness, they were less than satisfactory in providing accurate tax law answers during the 2004 Filing Season, with an accuracy rate of only 62 percent (200 of 322) of the calls monitored. This is a decrease from the 73 percent accuracy rate the TIGTA reported last year. This happened, for the most part, because CSRs were not always using the required Probe and Response Guide to obtain sufficient information from taxpayers or were not correctly interpreting the tax law. IRS results from a sample of 1,527 tax law calls monitored for customer accuracy during the same time period and for the same tax law applications indicated a customer accuracy rate of 74 percent (1,132 of 1,527 opportunities). The IRS’ FY 2004 tax law accuracy goal for CSRs was 85 percent.^{xv}

The IRS introduced the Kiosk Program in 1998 with 7 kiosks located in 3 states and has since expanded to 38 kiosks located in 20 states. The Kiosk Program is part of the IRS’ efforts to broaden its use of electronic interactions by providing more education and assistance through convenient, easy to use self-assistance channels. The IRS’ vision for the future of the Kiosk Program is to provide taxpayers with the ability to self-sufficiently resolve their own tax needs

¹² The period from January through mid-April when most individual income tax returns are filed.

and decrease the need for taxpayers to seek live assistance from the IRS at Taxpayer Assistance Centers (TAC). This would allow the IRS to refocus resources from the traditional profiling work of assisting taxpayers at the TACs to providing face-to-face assistance to taxpayers with compliance issues.^{xvi}

The IRS, however, cannot determine whether the Kiosk Program provides effective customer service or is cost-effective because of insufficient internal controls and management oversight. Even though the Kiosk Program has been in place since 1998, the IRS has yet to develop guidelines or processes to efficiently and effectively monitor the Program. For example, processes have not been developed to measure whether the Program is meeting its goal, ensure information provided on kiosks is current, accurate, and consistent, ensure kiosks are placed in the most optimal locations, and educate taxpayers on the benefits and locations of the kiosks.

Erroneous and Improper Payments

A component of *The President's Management Agenda* addresses erroneous payments. Also, the Improper Payments Information Act of 2002¹³ greatly expanded the Administration's efforts to identify and reduce erroneous and improper payments in Government programs and activities and, thus, improve the integrity of its payments. However, stewardship responsibility over public funds remains a major challenge facing IRS management.

Improper and erroneous payments include inadvertent errors, payments for unsupported or inadequately supported claims, payments for services not rendered, payments to ineligible beneficiaries, and payments resulting from outright fraud and abuse by program participants and/or Federal employees. For the IRS, improper and erroneous payments are generally associated with potentially erroneous refunds and filing fraud issues as well as vendor or contractor overpayments.

Some tax credits, such as the Earned Income Tax Credit (EITC), the Disabled Access Credit, and the Education Credit, provide opportunities for abuse in income tax claims. The EITC, for example, is a refundable credit available to taxpayers that file returns with certain earned income and a qualifying child. While the EITC has provided significant benefits to the working poor, it has also resulted in a significant loss of revenue to the Federal Government. An IRS compliance study of TY 1999 returns estimated between \$8.5 and \$9.9 billion (27 to 32 percent) of the \$31 billion in EITC claimed for TY 1999 should not have been paid.¹⁴

The IRS compares selected parts of taxpayer information furnished by the Social Security Administration to validate the identity and age of taxpayers and dependents claimed on each tax return. A recent TIGTA review^{xvii} reported, however, that not all of the data available to the IRS is used to validate that only qualifying children are claimed for EITC purposes or to identify tax returns that may be improperly using the Social Security Numbers (SSN) of deceased individuals. The TIGTA estimates there were over 10,000 tax returns filed for TY 2002 with over \$16 million in potentially erroneous EITC because the claimed qualifying "child" was significantly older than the primary taxpayer. The TIGTA also estimated over

¹³ Pub. L. No. 107-300, 116 Stat. 2350.

¹⁴ IRS report, *Compliance Estimates for Earned Income Tax Credit on 1999 Returns* (dated February 2002).

22,000 tax returns for TY 2001 improperly included the SSNs of deceased individuals so that the tax return filers could obtain \$21 million in erroneous tax benefits.

Contract expenditures represent a significant outlay of IRS funds and are, therefore, also susceptible to mistakes as well as abuse. As of September 2003, the IRS had approved payment of approximately \$750 million for the BSM contract. A TIGTA audit^{xviii} reported that initially neither the IRS nor the contractor could provide proper supporting documentation for approximately \$9.5 million (approximately 54 percent of the \$17.6 million sampled) in direct charges. The contractor did subsequently provide additional documentation, and TIGTA was able to verify all but approximately \$52,200. Nevertheless, to assure that its billings are adequately justified and to facilitate timely independent reviews, the IRS should strengthen its invoice review process by routinely requesting and reviewing a sample of supporting documents.

Processing Returns and Implementing Tax Law Changes During the Tax Filing Season

The filing season affects individual taxpayers and is always a highly critical program for the IRS. It is during the filing season that most individuals file their income tax returns and call the IRS if they have questions about specific tax laws or filing procedures. Correctly implementing tax law changes is a continuing challenge because the IRS must identify the tax law changes; revise the various tax forms, instructions, and publications; and reprogram the computer system used in processing returns.

The 2004 Filing Season included new and significant tax law changes created by the Jobs and Growth Tax Relief Reconciliation Act of 2003¹⁵ (JGTRRA) and the Military Family Tax Relief Act of 2003.¹⁶ Changes to the tax law can have a major effect on how the IRS conducts its activities, how many resources are required, and how much progress can be made on strategic goals. Generally, the Congress makes changes to the tax law each year, so some level of change is a normal part of the IRS environment. However, certain kinds of changes can significantly impact the IRS in terms of the quality and effectiveness of service and in how taxpayers perceive the IRS.

During the 2004 Filing Season, the IRS processed individual income tax returns in seven Submission Processing sites. Tax returns and related schedules are processed through the IRS' computer system and recorded on each individual's tax account at these sites. The IRS' computer system is made up of a complex series of processing sub-systems that are nationally linked and programmed to check the validity and accuracy of the return data provided. If an error is found, taxpayers are sent a notice that either requests additional information or explains any change the IRS made to the amount of the tax due or the refund.

Overall, the 2004 Filing Season was successful and most of the 123.1 million individual income tax returns received through May 28, 2004, (including over 60 million received electronically, an increase of nearly 16 percent over 2003) were timely and accurately processed. The TIGTA determined that the IRS correctly implemented the key tax law changes that affected TY 2003 returns. However, the TIGTA continues to identify tax law changes that were previously reported that have not yet been effectively implemented and

¹⁵ Pub. L. No. 108-27, 117 Stat. 752.

¹⁶ Pub. L. No. 108-121.

could result in loss of taxpayer entitlements and erroneous tax reductions. For example, the TIGTA identified taxpayers that are continuing to receive erroneous deductions for student loan interest, taxpayers with potentially unclaimed Additional Child Tax Credits, and taxpayers that were allowed questionable “dual benefits” for the tuition and fees deduction and the education credit.^{xix}

Taxpayer Protection and Rights

The IRS has dedicated significant attention and resources toward implementing the provisions of the RRA 98 that increase or further protect taxpayer rights. The RRA 98 also requires the TIGTA to review 10 of the 71 taxpayer rights provisions, as well as 2 other taxpayer rights provisions in prior legislation. FY 2004 is the sixth year in the cycle of TIGTA reviews assessing the mandatory RRA 98 provisions. The TIGTA's most recent audit results on these taxpayer rights provisions are:

- **Notice of Levy** – TIGTA reports have recognized that the IRS has implemented tighter controls over the issuance of systemically generated levies, and TIGTA testing of these controls indicated that they continue to function effectively. However, revenue officers who issue levies manually still are not always properly notifying taxpayers of their appeal rights.^{xx}
- **Restrictions on the Use of Enforcement Statistics to Evaluate Employees** – The IRS is complying with the law. A sample review of employee performance and related supervisory documentation revealed no instances of tax enforcement results, production quotas, or goals being used to evaluate employee performance.^{xxi}
- **Notice of Lien** – The IRS did not completely comply with the law. For example, the IRS did not always timely mail the lien notices. In other cases, the IRS could not provide proof of mailing. In addition, the IRS did not always follow its guidelines for notifying taxpayer representatives and for receipting and maintaining certified mail listings.^{xxii}
- **Seizures** – The IRS did not always comply with legal provisions and internal procedures when conducting seizures. The TIGTA review did not identify any instances where the taxpayers were adversely affected, but not following legal and internal guidelines could result in abuses of taxpayer rights.^{xxiii}
- **Illegal Tax Protestor Designations** – The IRS has not reintroduced past Illegal Tax Protestor (ITP) codes on the Master File,¹⁷ formerly coded ITP taxpayer accounts have not been assigned similar designations, and the IRS does not have any current publications with ITP references. However, a few ITP references still exist in manuals, job aids, computer systems, and isolated case files.^{xxiv}
- **Assessment Statute of Limitations** – Case files did not always document that taxpayers were advised of their rights regarding assessment statute extensions, and current consent forms¹⁸ do not provide an explanation of the taxpayers' rights to limit or refuse to extend the assessment statute of limitations. In addition, dual notification on joint tax returns and taxpayer representative notices were not always documented.^{xxv}

¹⁷ The Master File is the IRS' database that stores various types of taxpayer account information. This database includes individual, business, and employee plans and exempt organizations data.

¹⁸ The IRS uses several different types of consents, depending on the type of tax involved. For example, *Consent to Extend the Time to Assess Tax* (Form 872) is used for income taxes, and *Consent to Extend the Time to Assess Employment Taxes* (Form SS-10) is used for employment taxes.

- **Denials of Requests for Information** – The IRS improperly withheld information from requesters in 4.4 percent of the Freedom of Information Act¹⁹ and Privacy Act of 1974²⁰ requests, and 14.6 percent of the Internal Revenue Code § 6103 requests reviewed.^{xxvi}
- **Collection Due Process** – The Appeals Officers and Settlement Officers (hearing officers) substantially complied with the requirements of the law when conducting Collection Due Process hearings. However, the hearing officers did not always address all the issues raised by the taxpayers.^{xxvii}
- **Fair Debt Collection Practices Act Violations** – None of the 55 cases coded as potential violations and closed on the Automated Labor and Employee Relations Tracking System (ALERTS)²¹ during Calendar Year 2003, resulted in a reportable administrative action against an IRS employee. In addition, there were no civil actions identified that resulted in the IRS paying monetary settlements to taxpayers because of a violation.^{xxviii}

Neither the TIGTA nor the IRS could evaluate the IRS' compliance with three RRA 98 provisions since IRS management information systems do not track the specific cases:

- *Restrictions on directly contacting taxpayers instead of authorized representatives.*
- *Taxpayer complaints.*
- *Separated or divorced joint filer requests.*

Human Capital

Human capital remains a serious concern at the IRS. In fact, workforce issues, ranging from recruiting to training and retaining employees, have challenged Federal agencies for many years. The GAO named the area as a major challenge, and, in 2001, *The President's Management Agenda* proposed an aggressive strategy for improving the management of the Federal Government, including human capital issues. Thus, the OMB, the Office of Personnel Management, and the GAO have all made the strategic management of human capital a top priority. In addition to traditional workforce issues, the IRS also faces problems associated with its recent reorganization and modernization efforts. For example, as the IRS moves toward more *e-filing*, many jobs dealing with processing paper tax returns will no longer be necessary.

The Large and Mid-Size Business Division reported in its FY 2006 strategic assessment that it will continue to incur substantial loss of experience in the Revenue Agent occupation through attrition, thereby threatening the Division's ability to meet program requirements and the expectations of both external and internal customers. Similarly, in the SB/SE Division, the human capital crisis continues to intensify as employees in key occupational series increasingly become retirement eligible, are lost through attrition, or migrate to other areas. Stagnant funding allocations have impacted the ability to attract new hires and retain existing employees. Thus, potential losses in critical occupational groups (e.g., Revenue Agents, Revenue Officers, Tax Compliance Officers), coupled with concerns

¹⁹ 5 U.S.C. § 552.

²⁰ 5 U.S.C. § 552a.

²¹ The Workforce Relations Division's ALERTS generally tracks employee behavior that may warrant IRS management administrative actions.

regarding grade and competency gaps, further emphasize the need to strategically manage human capital.

The TE/GE Division is already understaffed for its current volume of customer calls. The Division's toll-free service is still maturing and acquiring new customers; however, without additional staffing or system enhancements, the level of service will deteriorate. This issue requires immediate attention because the Division relies on good toll-free customer service to help ensure voluntary compliance among its customers, since it has very limited resources for more traditional compliance activities like examinations.

In contrast, the Wage and Investment Division has reported that it has made significant progress in the human capital area. Examples include the increased use of electronic learning and training by demand for employees, and improved technical assessments for identifying skill levels and training needs of employees. In addition, the Division effectively planned and realigned its workforce as the result of reduced workload demands and technological changes which employ effective human resource strategies and procedures. Even so, more work needs to be completed to attract and retain high-quality employees, to increase productivity and quality, and to provide equal employment opportunities for all employees.

The CI function has also moved forward in this area. The function is implementing a computer-based knowledge management program, Communities Accessing and Sharing Expertise, which allows immediate identification of current subject matter experts. Skill transfer programs will be implemented to provide continuity of technical subject matter expertise, and continuing education programs will provide updated training on emerging issues, strategies, and operational priority subjects.

TIGTA audits indicate that the President's FY 2005 budget may offer some relief in staffing shortages; however, the overall training and acclimation process will take some time. In addition, although the Department of the Treasury has finalized its Human Capital Strategic Plan, some efforts to implement this plan may be delayed. For example, the Department of Treasury is now first focusing on cascading the qualities of the Senior Executive Service performance plans (alignment with mission, goals, etc.) to managers.

Attachment



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TIGTA AUDITS CITED:

- ⁱ *Annual Assessment of the Business Systems Modernization Program* (Reference Number 2004-20-107, dated June 2004).
- ⁱⁱ *Trends in Compliance Activities Through Fiscal Year 2003* (Reference Number 2004-30-083, dated April 2004).
- ⁱⁱⁱ *The Use of Anti-Money Laundering Referrals and Currency Transaction Information in the Income Tax Examination Process Could Be Improved* (Reference Number 2004-30-074, dated March 2004).
- ^{iv} *While Progress Toward Earlier Intervention With Delinquent Taxpayers Has Been Made, Action Is Needed to Prevent Noncompliance With Estimated Tax Payment Requirements* (Reference Number 2004-30-040, dated February 2004).
- ^v *The Tax Exempt and Government Entities Division Strategy for Abusive Tax Avoidance Transactions Needs Further Development* (Reference Number 2004-10-190, dated September 2004).
- ^{vi} *Courts Are Not Always Notified When Criminals Fail to Comply With Their Sentences to Settle Civil Tax Liabilities* (Reference Number 2004-10-060, dated March 2004).
- ^{vii} *Computer Security Roles and Responsibilities and Training Should Remain Part of the Computer Security Material Weakness* (Reference Number 2004-20-155, dated September 2004).
- ^{viii} *Weaknesses in the Modernization Infrastructure Have Not Been Adequately Addressed* (Reference Number 2004-20-132, dated August 2004).
- ^{ix} *The Certification and Accreditation of Computer Systems Should Remain in the Computer Security Material Weakness* (Reference Number 2004-20-129, dated August 2004).
- ^x *Sensitive Technology Information Was Posted on the Internet* (Reference Number 2004-20-046, dated February 2004).
- ^{xi} *The Use of Personal Digital Assistants Poses Significant Security Risks* (Reference Number 2004-20-126, dated July 2004).
- ^{xii} *The Integrated Financial System Software Does Not Comply With Some Accounting Standards or Contain Certain Functionality as Originally Asserted by the Vendor* (Reference Number 2004-10-187, dated September 2004).
- ^{xiii} *Review of the Nationwide Electronic Tax Forum Conferences and Exhibitions Contract* (Reference Number 2004-10-128, dated July 2004).
- ^{xiv} *Taxpayers Experienced Improved Access to Toll-Free Telephone Services During the 2004 Filing Season* (Reference Number 2004-30-144, dated August 2004).
- ^{xv} *Additional Effort Answering Tax Law Questions Would Improve Customer Service* (Reference Number 2004-40-150, dated August 2004).
- ^{xvi} *The Effectiveness of the Kiosk Program Cannot Be Determined* (Reference Number 2004-40-151, dated August 2004).
- ^{xvii} *Better Use of the National Account Profile During Returns Processing Can Eliminate Millions of Dollars in Erroneous Payments* (Reference Number 2004-40-098, dated May 2004).
- ^{xviii} *Improvements Are Needed in the Invoice Review Process for the Business Systems Modernization Contract* (Reference Number 2004-10-117, dated June 2004).
- ^{xix} *The 2004 Filing Season Was Completed Timely and Accurately, but Some Tax Law Changes Have Not Been Effectively Implemented* (Draft report dated October 2004).
- ^{xx} *Additional Efforts Are Needed to Ensure Taxpayer Rights Are Protected When Manual Levies Are Issued* (Reference Number 2004-30-094, dated April 2004).
- ^{xxi} *Fiscal Year 2004 Statutory Audit of Compliance With Legal Guidelines Restricting the Use of Records of Tax Enforcement Results* (Reference Number 2004-40-066, dated March 2004).
- ^{xxii} *Fiscal Year 2004 Statutory Review of Compliance With Lien Due Process Procedures* (Reference Number 2004-30-086, dated April 2004).
- ^{xxiii} *Legal and Internal Guidelines Were Not Always Followed When Conducting Seizures of Taxpayers' Property* (Reference Number 2004-30-149, dated August 2004).
- ^{xxiv} *Fiscal Year 2004 Statutory Audit of Compliance With Legal Guidelines Prohibiting the Use of Illegal Tax Protester and Similar Designations* (Reference Number 2004-40-109, dated June 2004).
- ^{xxv} *Fiscal Year 2004 Statutory Audit of Compliance With Notifying Taxpayers of Their Rights When Requested to Extend the Assessment Statute* (Reference Number 2004-40-108, dated June 2004).
- ^{xxvi} *Improvements Are Needed to Ensure Compliance With the Freedom of Information Act* (Reference Number 2004-40-064, dated March 2004).
- ^{xxvii} *Appeals Complied With the Provisions of the Law for the Collection Due Process* (Reference Number 2004-40-067, dated March 2004).
- ^{xxviii} *Fair Tax Collection Practices Violations Did Not Result in Administrative or Civil Action* (Reference Number 2004-40-143, dated July 2004).

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